IT 01-5
Tax Type: **Income Tax**
Issue: **Bad Debt Write-Off**
Audit Methodologies and/or Other Computational Issues
Unitary Apportionment

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

"ASSOCIATED SAVINGS BANK", et al Taxpayers	Docket No.	98-IT-0000
	FEIN:	00-0000000
v.	Tax Year Ending	11/30/93
THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	John E. White, Administrative Law Judge	

ORDER OF DISPOSITION FOLLOWING
THE PARTIES' CROSS-MOTIONS FOR SUMMARY JUDGMENT

Appearances: Fred Marcus, et. al, Horwood Marcus & Berk, appeared for "Associated Savings Bank & Affiliates"; Ralph Basset, Special Assistant Attorney General, appeared for the Illinois Department of Revenue

Synopsis:

This matter involves an amended return/claim for refund filed by "Associated Savings Bank" ("ASB" or "taxpayer") on behalf of itself and certain affiliates regarding tax year 1993. After a period of discovery, the parties agreed to proceed via cross-motions for summary judgment.

The issue involves certain subtraction modifications "ASB" claimed on its original and amended returns, including subtractions for: (1) the amount of "ASB's" § 593(e)(2) bad debt reserves required to be included in "ASB's" federal taxable income for 1993; (2) the amount of inter-company gain attributable to interest accruing using the "Rule of 78's" method of accounting for interest, which method "ASB" used for financial

accounting purposes; and (3) the amount of the income and losses of members of "ASB's" unitary business group, but which amounts were not included in the "ASB" group's combined federal taxable income as reported on its original and amended returns. "ASB" contends that, as a matter of law, such amounts must be deducted from its combined federal taxable income when calculating its Illinois base income. The Department contends that no authority exists for "ASB" to make such subtraction modifications.

I have reviewed the parties' motions and the documents and affidavits supporting them, and I am including in this recommendation a statement of material facts not in dispute, and conclusions of law. I recommend that the Director deny "ASB's" motion, that he grant the Department's motion, and that he issue a final decision denying "ASB's" claim.

Statement of Facts Not in Dispute

1. During the period at issue, from January 1, 1993 through November 30, 1993, "ASB" was a wholly owned subsidiary of "Big Retail Company" ("BRT"). Taxpayer's Motion for Summary Judgment ("TMSJ") Ex. 1 (Affidavit of "Jimmy "Olsen"", ¶ 5 (hereinafter ""Olsen" Aff. ¶ [ ]")).
2. "ASB" was headquartered in "Someplace", California, where it operated a retail savings and loan branch. ""Olsen"" Aff. ¶ 6.
3. "ASB" also operated approximately ninety traditional retail savings and loan branches throughout California. "Olsen" Aff. ¶ 7.
4. By the end of 1987, "ASB" had either closed or sold all of its retail branches, except for the branch located at its "Someplace" facility. "Olsen" Aff. ¶ 8.

5. "ASB" established an agency office in Illinois in 1989. "Olsen" Aff. ¶ 9.

6. "ASB" did not operate any savings and loan branches or otherwise do business in any state other than California before opening its office in Illinois. "Olsen" Aff. ¶ 10.

7. Before tax year 1989, "ASB" did not file an income tax return in Illinois. "Olsen" Aff. ¶ 11.

8. On November 30, 1993, "BRT" sold "ASB" and certain horizontally integrated affiliates to "ABC" Bank Corporation. TMSJ Ex. 4, p. 21 (first page of federal form 8023 and related attachments).

Facts Regarding the Subtraction Modification "ASB" Claimed For Its § 593(e)(2) Bad Debt Reserve Recapture

9. Section 593(a)(1) of the Internal Revenue Code ("the Code" or "IRC") allows certain savings and loan banks, like "ASB", to claim as a deduction from gross income the amount of reasonable additions to a qualifying reserve for bad debts. 26 U.S.C. § 593(a)(1), (c)(1).

10. When a savings and loan bank makes a liquidating distribution to its shareholders, § 593(e)(2) of the Code requires the bank to recapture and include in federal taxable income the amounts it previously deducted as part of its qualifying reserve for bad debts, i.e., its "loan loss reserve." 26 U.S.C. § 593(e)(2).

11. "BRT"' November 1993 sale of "ASB" triggered a § 593(e)(2) loan loss reserve recapture. "Olsen" Aff. ¶ 12.

12. "ASB" included its loan loss reserve in gross income for the year at issue. "Olsen" Aff. ¶ 12. The § 593(e)(2) recapture amount was $132,918,034. "Olsen" Aff. ¶ 12.

13. "ASB" computed the federal tax basis of its loan loss reserves annually. "Olsen" Aff. ¶ 13.

14. On December 31, 1988, "ASB's" "qualifying loan reserve" balance was $104,921,639, and its "supplemental loan loss reserve" balance was $31,149,041. "Olsen" Aff. ¶ 14.

15. On December 31, 1992, "ASB's" "qualifying loan loss reserve" balance was $109,494,450, and its "supplemental loan loss reserve" balance remained at $31,149,041. "Olsen" Aff. ¶ 15; *see also* 26 U.S.C. § 593(c)(1).

16. The increase in the "qualifying loan loss reserve" balance between December 31, 1988 and December 31, 1992 was $4,572,81. "Olsen" Aff. ¶¶ 14-15.

17. When calculating its Illinois base income on the original Illinois combined tax return for tax year ending November 31, 1993, "ASB" claimed the amount of $141,658,366 as a subtraction modification from federal taxable income. TMSJ Ex. 2, p. 1 (Part I, lines 5(f) & 6).

18. Of this total subtraction, "ASB" attributes $128,345,226 as the portion of its total § 593(e)(2) recapture amount that is attributable to its qualifying loan loss reserve deductions which "ASB" claimed prior to 1989. TMSJ Ex. 4, pp. 1 (Part 1, line 5b), 12 (detail information for amounts reported on "ASB's" Schedule UB, Part III, line 5f, as set forth in Statement 7 of "ASB's" 1993 amended Illinois return). This figure equals the difference between $132,918,034 - the total loan loss reserve recapture amount – and $4,572,811 - the increase in "qualifying loan loss reserve" between December 31,1988 and December 31, 1992. TMSJ Ex. 4, pp. 1, 12; *see also* TMSJ Ex. 2, p. 1 ("ASB's" detailed Statement 1, referred to on Part I,

line 5f of "ASB's" original combined Illinois form IL-1120, is not included in that exhibit).

Facts Regarding the Subtraction Modification Claimed for the Amount of Interest Accruing Using the Rule of 78's

19. When calculating its combined Illinois base income for tax year ending November 31, 1993, "ASB" claimed the amount of $3,042,622 as an "other" subtraction modification from federal taxable income. TMSJ Ex. 2, p. 1 (Part I, line 5f); TMSJ Ex. 4, pp. 1 (Part 1, line 5b), 12 (Statement 7). That amount is attributable to the reversal of a deferred inter-company gain and the Rule of 78's interest method. *See* "Olsen" Aff. ¶¶ 17-21; TMSJ Ex. 4, pp. 1, 12.

20. "ASB" provided financing for consumer loans originated by an affiliate. "Olsen" Aff. ¶ 16.

21. For financial accounting purposes, "ASB" used the Rule of 78's method to record interest income from these loans. "Olsen" Aff. ¶ 17.

22. Under this method, the amount of interest allocable to each period is figured by multiplying the total interest payable over the life of a loan by a fraction. *See* Rev. Rul. 83-84, 1983-1 C.B. 97 (June 6, 1983) (hereinafter "Rev. Rul. 83-84"). The numerator of the fraction is the number of periods remaining on the indebtedness when the calculation is performed, and the denominator is the sum of the periods' digits for the term of the indebtedness. *Id*.

23. In 1983, the Internal Revenue Service ("IRS") issued Revenue Ruling 83-84, which notified accrual taxpayers that, for federal income tax reporting purposes, it would not recognize a taxpayer's use of the Rule of 78's to report interest income.

Rev. Rul. 83-84; *see also* "Olsen" Aff. ¶ 18 (referring to "… a federal change in allowable methods of reporting interest income in 1984 ….").

24. Because "ASB" used the Rule of 78's for financial reporting or "book" purposes at a time when that same accounting method could not be used for tax reporting purposes, a book/tax difference was created on the loans originated by "ASB's" affiliate and purchased by the bank. "Olsen" Aff. ¶¶ 17-18.

25. Prior to 1989, that is to say, before "ASB" became an Illinois taxpayer, "ASB" sold the loans back to the originating affiliate at book value. "Olsen" Aff. ¶ 19.

26. For federal income tax purposes, "BRT"' sale of "ASB" triggered a deferred inter-company gain for "ASB". "Olsen" Aff. ¶ 20. The recognition of this gain was deferred under Treas. Reg. § 1.1502-13. *Id*.

27. "ASB" recognized the deferred inter-company gain ratably as the loans were repaid to the originating affiliate. "Olsen" Aff. ¶ 21.

28. The $3,042,622 "ASB" subtracted from "ASB's" federal taxable income when calculating its Illinois base income represents the amount of deferred intercompany gain it was required to recognize during the year at issue, for federal income tax purposes, and which amount relates to the prior deductions "ASB" had taken before the bank began doing business in Illinois. *See* TMSJ Ex. 4, pp. 1, 12.

Facts Regarding the Subtraction Modification Claimed for the Income and/or Losses Attributable to Claimed Members of "ASB's" Unitary Business Group

29. The remaining $10,270,521 "ASB" claims as a subtraction from federal taxable income is attributable to the income or loss of certain members of "ASB's" Illinois unitary business group ("UBG"). TMSJ Ex. 4, pp. 1, 12-13.

30. "ASB" filed an Illinois combined return for the year ending 11/30/93. TMSJ Ex. 2, p. 4 (Part I of Schedule UB); DSMJ, Ex. 2.

31. On its original and amended returns, "ASB" reported the following corporations as members of its Illinois UBG:

Corporation	FEIN
"BRT Saving Bank"	
"BRT Mortgage Corp."	
"BRT Mortgage Securities Corp."	
"BRT Mortgage Funding Corp."	
"#1 Services Corp."	
"#2 Services Corp."	
"Brownbelly Corp."	
"Astro Funding Corp"	
"LaBrea Properties, Inc."	
"BRT Residential Finance Corp."	
"Ancient Corp."	

Department's Response to Taxpayer's Motion for Summary Judgment and Department's Cross Motion for Summary Judgment ("DMSJ") Ex. 2, pp. 5 ("ASB's" Schedule UB, Part I § B), 20-21 (detailed list of the members in "ASB's" Illinois unitary business group); TMSJ Ex. 4, pp. 8-9 (same list included with exhibit of "ASB's" amended Illinois return).

32. When "BRT" sold "ASB" in November 1993, it also sold certain, but not all of "ASB's" affiliates. "Olsen" Aff. ¶ 22-24; TMSJ Ex. 4, pp. 21-23.

33. "BRT" did not sell "Brownbelly Corp.", "Astro Funding Corp.", "LaBrea Properties, Inc.", "BRT Residential Finance Corp." and "Ancient Corp." "Olsen" Aff. ¶ 24.

34. Despite being identified as the members of "ASB's" Illinois UBG, "ASB" did not include the federal taxable income and/or losses of "Brownbell Corp.", "Astro Funding Corp.", "LaBrea Properties, Inc.", "BRT Residential Finance Corp." and "Ancient Corp." within its statement of the group's combined federal taxable income, as reported on line 1 of "ASB's" original Illinois combined return for the

year at issue. TMSJ ¶ 36; TMSJ Ex. 2, p. 1 (Part I, lines 5(f), 6). Nor were those items of income and/or loss for each respective corporation reported on lines 28 of Part II of "ASB's" Schedule UB, or on line 1 of Part III of that schedule. TMSJ Ex. 2, pp. 8-9 (Part II of Schedule UB), 13-14 (Part III of Schedule UB).

35. Instead, the federal taxable income and/or losses of "Brownbelly Corp.", "Astro Funding Corp.", "LaBrea Properties, Inc.", "BRT Residential Finance Corp." and "Ancient Corp." were reported as subtractions from the group's combined federal taxable income. TMSJ ¶ 37; TMSJ Ex. 2, pp. 8-9 (Part II of form IL-1120, line 5(f)), 12-13 (Part III, line of Schedule UB).

36. "ASB's" statement of the "unitary income of excluded members," as reported on its Illinois original and amended returns, is generally 11/12 of the federal taxable income of those corporations. "Olsen" Aff. ¶ 27; TMSJ Ex. 4, pp. 12-13 (Statement 7).

37. "ASB" and the members of its Illinois unitary business group whose federal taxable income was included in Part I line 1 of "ASB's" Illinois combined return had a taxable year that ended on 12/31/93. TSMJ Ex. 4, pp. 2, 15-24. "ASB's" Illinois combined returns used a tax year ending on 11/30/93 because "ASB" and other of its affiliates were sold on that date. TSMJ Ex. 4, pp. 2, 15-24.

38. On attachments "ASB" included with its Illinois combined form IL-1120 and with its IL-1120-X, it reported that "Brownbelly Corp.", "Astro Funding Corp.", "LaBrea Properties, Inc.", "BRT Residential Finance Corp." and "Ancient Corp." all had an Illinois reporting obligation. DMSJ Ex. 2 ("ASB's" original form IL-

1120), pp. 20-21 (Statement 3); TMSJ Ex. 4, pp. 8-9 (same Statement 3 included in "ASB's" form IL-1120-X).

Fact Regarding the Timing of "ASB's" Returns

39. "ASB", on behalf of itself and certain affiliates, filed its original Illinois combined tax return for the year at issue on October 11, 1994. DMSJ Ex. 2; TMSJ Ex. 2. The return disclosed an overpayment of $1,670,000 and requested a refund of this amount. DMSJ Ex. 2; TMSJ Ex. 2.

40. On August 15, 1995, "ASB" sent the Department a letter asking for a refund of the amount disclosed on the original return as an overpayment. TMSJ Ex. 3.

41. On September 12, 1997, "ASB" filed an amended return for the year at issue, again requesting the $1,670,000 refund. TMSJ Ex. 4.

42. The amended return, however, did not amend any aspect of "ASB's" original combined return. TMSJ Ex. 4. Specifically, the return did not include the income and/or losses of "Brownbelly Corp.", "Astro Funding Corp.", "LaBrea Properties, Inc.", "BRT Residential Finance Corp." and "Ancient Corp." as a proposed change to Part I, line 1 of "ASB's" form IL-1120, i.e., "ASB's" statement of the group's combined federal taxable income. *Id*. Instead, the return repeated all of the identical entries from its original return. *Id*.

43. The Department neither approved nor denied the "ASB's" amended return within six months from when the claim was filed. TMSJ ¶ 42; DMSJ, p. 4.

44. On September 2, 1998, "ASB" protested the deemed denial of its refund claim. DMSJ Ex. 4.

Fact Not Presented By the Parties' Cross-Motions

45. There are no well-pleaded facts from which it might be determined whether "Brownbelly Corp.", "Astro Funding Corp.", "LaBrea Properties, Inc.", "BRT Residential Finance Corp." and "Ancient Corp." had any properly reportable addition and/or subtraction modifications to be taken into account when calculating each corporation's Illinois base income. *Compare* DMSJ Ex. 2, pp. 10-11 ("ASB's" Schedule UB, Part III, for members whose federal taxable income was included on Part I, line 1 of "ASB's" form IL-1120) *with id*., pp. 12-13 ("ASB's" Schedule UB, Part III for members whose federal taxable income was excluded on Part I, line 1 of "ASB's" form IL-1120); *see also*, 1993 Instructions to Schedule UB.[1]

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[1] The 1993 Schedule UB instructions state, in pertinent part:

> **Part II — Computation of federal taxable income or equivalent**
>
> * * * *
>
> **Computing federal taxable income (or net operating loss)** — All members of the unitary business group must include their federal taxable income (loss) in Part II.
>
> Federal taxable income (loss) in Part II of the Schedule UB means "separate taxable income" that would be computed by each member for purposes of a federal consolidated return and its supporting statements in accordance with IRS Regulation Section 1.1502-12. For Illinois income tax purposes, the federal taxable income (loss) of each member of the unitary group is written on Line 30.
>
> * * * *
>
> **Part III — Computation of unitary business group income**
>
> Generally, these items correspond to lines on Form IL-1120, Parts I and III. For specific line information, refer to Form IL-1120 instructions. Schedules used to compute any amounts shown **must** be attached to the IL-1120.
>
> Line 1 — Write the federal taxable income (loss) for Illinois purposes from Part II, Column E, Line 30.
>
> **Columns A, B and C**
>
> Write the FEIN and financial amounts for each member of the unitary business group listed in Part I, Section B.
>
> * * * *
>
> **Specific Instruction for Completing Form IL-1120**

Conclusions of Law:

A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 **ILCS** 5/2-1005; People ex rel Department of Revenue v. National Liquors Empire, Inc., 157 Ill. App. 3d 434, 437, 510 N.E.2d 495, 498 (4th Dist. 1987). Here, there is no dispute regarding the following material facts: the amounts of the subtractions at issue and what those amounts represent; the corporations named as being members of "ASB's" Illinois UBG; which of "ASB's" members' income and/or losses were included in Part 1, line 1 of "ASB's" Illinois original and amended combined income and replacement tax returns; and how the amounts of each group member's income and/or losses were reported on those returns. After briefly summarizing how a taxpayer's Illinois base income is calculated, I will address each party's motion separately.

The Illinois income tax is measured by a taxpayer's net income. 35 **ILCS** 5/201(a). A taxpayer's "net income" is defined by § 202 of the IITA as "… that portion off his base income for such year … which is allocable to this state under the provisions of Article 3, less the standard exemption allowed by Section 204 and the deduction allowed by Section 207." 35 **ILCS** 5/202.

Section § 203 defines the term "base income." 35 **ILCS** 5/203. For each taxpayer subject to Illinois income tax, its base income equals its federal taxable income (or, in the

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> The amounts to be transferred to Form IL-1120 will be taken from Schedule UB, Parts II, III, and IV. For specific line information, refer to Form IL-1120 instructions.
>
> * * * *

case of an individual, its adjusted gross income) as modified by adding some amounts (called addition modifications or additions) to its federal taxable income, and then by subtracting some other amounts (called subtraction modifications or subtractions) from the sum of its federal taxable income and its Illinois additions. 35 **ILCS** 5/203(a)-(e).

The subtraction modifications the Illinois General Assembly made available for corporations are also, and always have been, set forth in § 203 of the IITA. *Compare* 35 **ILCS** 5/203 (2000) *with* Ill. Rev. Stat. ch. 120, ¶ 2-203 (1969). Those subtractions are deductions that are taken from the taxpayer's federal taxable income when calculating Illinois taxable income. 35 **ILCS** 5/203(b)(2); Bodine Electric Co. v. Allphin, 81 Ill. 2d 502, 512-13, 410 N.E.2d 828, 833 (1980).

During the years at issue, the subtractions the Illinois General Assembly allowed to be taken from a corporate taxpayer's federal taxable income were expressly limited to those described in § 203(b)(2)(F) through (Q). 35 **ILCS** 5/203(b) (first codified at Ill. Rev. Stat. ch. 120, ¶ 2-203(f)(4) (1971)). I say that these subtractions were expressly limited to those described in subparagraphs (F) through (Q) of § 203(b) because of § 203(h), in which the Illinois General Assembly set forth its specific intent that:

> [e]xcept as expressly provided by this Section there shall be no modifications or limitations on the amounts of income, gain, loss or deduction taken into account in determining gross income, adjusted gross income or taxable income for federal income tax purposes for the taxable year, or in the amount of such items entering into the computation of base income and net income under this Act for such taxable year, whether in respect of property values as of August 1, 1969 or otherwise.

35 **ILCS** 5/203(h); Bodine Electric Co., 81 Ill. 2d at 512-13, 410 N.E.2d at 833.

1993 Instructions to Schedule UB (underlined emphasis added, boldface original).

Bases for "ASB's" Motion

"ASB's" motion first asserts that, as a matter of law, the federal tax benefit doctrine[2] requires that it be given an Illinois subtraction for the "recaptured" amount § 593(e)(2) required it to include within federal taxable income, which was related to its prior bad debt reserve deductions. Memorandum in Support of Taxpayer's Motion for Summary Judgment ("ASB's" Brief), pp. 2-3; 26 U.S.C. § 593.

"ASB" accepts that the Illinois General Assembly provided no statutory counterpart to the tax benefit doctrine within the IITA, yet it urges that the doctrine "… should be recognized by Illinois. "ASB's" Brief, p. 3.[3] "ASB" asserts that the tax benefit doctrine should be recognized in this case, and its recaptured amounts must, as a matter of law, be subtracted from its federal taxable income, because Illinois' "… tax system is patterned generally after the federal income tax system, [and] the same general principles and rules that govern the federal system should be recognized by Illinois." *Id*. "ASB" further argues that keeping the recapture amount as part of its Illinois base income inherently distorts the amount of income attributable to its operations in Illinois, because most of the amounts recaptured are related to transactions taken before "ASB" began to operate in Illinois. *Id*., pp. 3-4.

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[2] The tax benefit doctrine was originally judicially created, and later codified by Congress as § 111 of the Code. 26 U.S.C. § 111.

[3] During the years at issue and currently, the IITA authorized a subtraction modification to be taken by an individual taxpayer for amounts included within the taxpayer's adjusted gross income "… pursuant to the provisions of § 111 of the [Code] as a recovery of items previously deducted from adjusted gross income in the computation of taxable income." 35 **ILCS** 5/203(a)(2)(I). The legislature's creation of that particular subtraction modification, however, does not help "ASB" in this case, because "ASB" is not an individual taxpayer.

Second, "ASB's" motion argues that it must be allowed to deduct $3,042,622 in the deferred inter-company gain it was required to recognize for federal income tax purposes after "ASB" was sold in 11/93. That gain is related to the amounts "ASB" attributed to the interest income it received for financing consumer loans originated by an affiliate, using the Rule of 78's for financial accounting purposes.

Finally, "ASB" argues that the amount of the income and/or losses of companies it identified as members of its Illinois UBG on its original and amended returns should be subtracted from its combined federal taxable income ("ASB's" Brief, p. 5), even though it acknowledges that it did not include such amounts of income and/or loss on line 1 of its Illinois combined return, where it was required to report the group's combined federal taxable income. TMSJ, p. 8, ¶¶54-55; "Olsen" Aff. ¶¶ 25-26; *see also* 1993 Instructions to Form IL-1120 and Schedule UB.

Basis for the Department's Motion

The Department's primary challenge to "ASB's" motion is that § 203 of the IITA prohibits all of the subtractions claimed by "ASB". DMSJ, pp. 5-6. The Department's motion asserts that § 203(b)(2) provides no express deduction for any of the amounts "ASB" claims as a subtraction when calculating its combined Illinois base income. Second, the Department points out that § 203(h) expressly prohibits "ASB" from inventing and attempting to implement its own subtraction modifications when calculating Illinois base income. The Department argues that those two related sections of § 203 require that "ASB's" motion be denied, as a matter of law. *See id*.

Analysis of the Parties' Motions

"[W]hen a taxpayer claims that he is exempt from a particular tax, or where he seeks to take advantage of deductions or credits allowed by statute, the burden of proof is on the taxpayer." Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981). Since this matter involves "ASB's" claim that it is entitled to deduct certain specified amounts from its federal taxable income when calculating its Illinois base income, its motion should be granted if it sets forth facts showing a clear entitlement to the claimed deductions.

There can be no dispute that the amounts claimed by "ASB" are not within the Illinois General Assembly's exclusive list of the amounts that were available to be subtracted from a taxpayer's federal taxable income when calculating its Illinois base income. 35 **ILCS** 5/203(b)(2)(F)-(Q). And while § 203(b)(2) includes a "catch-all" subtraction modification that authorizes a deduction where required by the Illinois Constitution or by the Constitution, treaties or laws of the United States (35 **ILCS** 5/203(b)(2)(J)), "ASB" has never challenged the Department's denial of its refund on constitutional grounds. *See* TMSJ; "ASB's" Brief; Taxpayer's Response to Department's Motion for Summary Judgment ("ASB's" Reply). Since there is no express authority in § 203(b)(2) for any of the amounts claimed as subtractions by "ASB", I must conclude that § 203(h) of the IITA requires that "ASB's" motion, and its claims for refund, be denied. 35 **ILCS** 5/203(b)(2), (h); Bodine Electric Co., 81 Ill. 2d at 510, 410 N.E.2d at 832. That same section, correspondingly, requires that judgment be entered for the Department.

There are, however, additional reasons why "ASB's" claim that it is entitled to each subtraction amount, as a matter of law, should not be granted. I will discuss each such reason, in turn.

1. Loan Loss Reserve Recapture Amounts

More than twenty years ago, the Illinois supreme court held that just because a particular credit or deduction is authorized by the Code does not mean that a corresponding credit or deduction is thereby automatically subsumed within the IITA. In Bodine Electric Co., the court acknowledged that "… there is no provision in the [IITA] which specifically adopts all federally allowed deductions." Bodine Electric Co., 81 Ill. 2d at 510, 410 N.E.2d at 832. More specifically, the court expressly held that the legislature's adoption of federal taxable income as the starting point for calculating Illinois base income "… [did] not … create a parallel set of 'Illinois deductions.'" *Id.*

The Illinois General Assembly decided to use a taxpayer's federal taxable income as the starting point for determining its Illinois base income in order "... to simplify tax computation and to develop some degree of consistency in Federal and State income reporting." Bodine Electric Co., 81 Ill. 2d at 512, 410 N.E.2d at 833. "ASB's" prior bad debt reserve deductions recaptured pursuant to § 593(e)(2) of the Code were part of "ASB's" federal taxable income. "Olsen" Aff. ¶ 12. The recapture amounts were properly reportable for federal income tax purposes in 1993 (*see id.*; 35 **ILCS** 5/203(e)), and "ASB" had been conducting business in Illinois since 1989. "Olsen" Aff. ¶ 9. Thus, §§ 203 and 403 both require that such amounts be included within "ASB's" combined Illinois base income for the same year, just as they were for federal income tax purposes. 35 **ILCS** 5/203(b), (e), 5/403(a).

"ASB's" claim that including the recapture amounts in its Illinois base income results in distortion is also unavailing here. The statutory provision that provides a remedy for claimed distortion of the amount of business income derived from a taxpayer's activities in Illinois is § 304(f) of the IITA. 35 **ILCS** 5/304(f). This record, however, does not reflect that "ASB" ever filed a petition for § 304(f) relief. More importantly, the Illinois appellate court, in Rockwood Holding Co. v. Department of Revenue, recently upheld a trial court's determination that § 304(f) "only pertains to situations where the general statutory formulae for 'allocation and apportionment' fail to fairly represent the true extent of a taxpayer's activities within Illinois." Rockwood Holding Co., 312 Ill.App.3d 1120, 1126, 728 N.E.2d 519, 525 (1st Dist. 2000). This matter, as was the case in Rockwood, does not involve the allocation or apportionment of "ASB's" income. Rather, "ASB" claims distortion because §§ 203 and 403 of the IITA require it to include within its Illinois base income a particular item of income that was properly reportable for federal income tax purposes during the year at issue. Thus, even if "ASB" had petitioned for 304(f) relief, that section provides no relief here. Rockwood Holding Co., 312 Ill.App.3d at 1126, 728 N.E.2d at 525.

2. Rule of 78's Amounts

While "ASB" notes in its brief that the Rule of 78's was not allowable for federal tax purposes, what it does not disclose is *why* that method was not allowable. The answer is found in Revenue Ruling 83-84, which the Internal Revenue Service issued in 1983. In that ruling, the IRS notified all accrual taxpayers that, for tax reporting purposes, they would not be allowed to use the Rule of 78's method because it lacked economic substance. Specifically, that ruling stated, in pertinent part:

> The Rule of 78's represents a purely mechanical formula for allocating interest among periods. Because interest is earned by application of the effective rate of interest over the term of the loan, any agreement that provides that interest is earned in another manner, such as under the Rule of 78's computation, lacks economic substance because it fails to reflect the true cost of borrowing. No tax effect will be given to the Rule of 78's provision. Accordingly, a taxpayer that uses the accrual method of accounting may deduct in each year the interest that economically accrues and may not deduct any additional interest attributable to the Rule of 78's computation. See Rev. Proc. 83-40, page 22, this Bulletin, for an administrative exception to the application of the rules set forth herein for certain short-term consumer loans.

Rev. Rul. 83-84, 1983-1 C.B. 97 (emphasis added).[4]

Thus, the Rule of 78's was not and is not allowable for federal income tax purposes because the IRS determined that that method of accounting lacks economic substance. It lacks economic substance because it does not reflect either the true cost of borrowing (for the borrower), or the way interest income is actually earned (for the lender). *Id*. After taking into account the reason why the IRS does not allow accrual taxpayers to use the Rule of 78's for federal tax reporting purposes, I reject "ASB's" assertion that the same method must, *as a matter of law*, be used to provide it with a deduction when calculating its base income for Illinois income tax purposes. No provision in the IITA reveals a legislative intent to grant any deduction that is based on an accounting method that lacks economic substance, and no Illinois court, to my knowledge, has ever interpreted the IITA to so provide.

[4] Revenue Ruling 83-84 also defines the terms "interest," "effective rate of interest," and describes the operation of the Rule of 78's, the cash and accrual methods of accounting.

3. Income and Loss Amounts of Unitary Members Excluded on "ASB's" Original and Amended Returns

"ASB" contends that "… either the amount shown as 'unitary income of excluded members' must be excluded from base income, or the amount shown as combined federal taxable income must be reduced by an equal amount." TMSJ, p. 8 (¶ 57). Of course, what "ASB" was required to do, as a taxpayer who conducted business as a unitary group, was to include the income and/or losses of all of the members of "ASB's" unitary group on its Illinois returns on Part I, line 1 of its combined Illinois form IL-1120, when it reported the amount of the group's federal taxable income. TMSJ Ex. 2, p. 1. It did not do so. *Id.*; "Olsen" Aff. ¶ 25.

"ASB's" motion also asserts as a fact that its subtraction of the amounts of the companies' income and losses "… produc[ed] the same net effect as if the amounts were included in federal taxable income in the first place." TMSJ, p. 5 (¶ 37). That same statement is also set forth in "Olsen"'s affidavit. "Olsen" Aff. ¶ 26. That statement, however, is not a statement of a clear and unequivocal fact that is within the affiant's personal knowledge. Rather it is a conclusion, and a conclusion for which no well-pleaded facts are offered.

Illinois Supreme Court Rule 191 governs the nature and content of affidavits offered to establish facts in support of a party's motion for summary judgment. Ill. S.Ct. R. 191. That rule provides, in pertinent part:

> *** Affidavits in support of and in opposition to a motion for summary judgment under section 2--1005 of the Code of Civil Procedure, … shall be made on the personal knowledge of the affiants; shall set forth with particularity the facts upon which the claim, counterclaim, or defense is based; shall have attached thereto sworn or certified copies of all papers upon which the affiant relies; shall not consist

> of conclusions but of facts admissible in evidence; and shall affirmatively show that the affiant, if sworn as a witness, can testify competently thereto. ***

Ill. Sup. Ct. R. 191(a) (emphasis added); Kavales v. City of Berwyn, 305 Ill. App. 3d 536, 712 N.E.2d 842 (1st Dist. 1999). For reasons set forth below, I cannot accept "Olsen's" bare conclusion that "ASB's" filing position produced the same result as if had followed the instructions on how to properly report and calculate the combined Illinois base income of all members of its unitary business group.

A careful review of "ASB's" own Illinois returns show why the facts required to support "ASB's" argument — that "regardless of the propriety of or impropriety of the bank's method of reporting these amounts, the bank's return ultimately reports the same amount of base income for the year at issue" ("ASB's" Brief, p. 5) — are not clearly evident from this record. Those returns show that "ASB's" argument confuses the distinction between a taxpayer's "federal taxable income" and its Illinois "base income." For a corporation, "base income" equals "the amount of taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code", plus any and all of its applicable Illinois addition modifications, and then minus the sum of its Illinois subtraction modifications. 35 **ILCS** 5/203(b)(1)-(2), (e).

When a corporation conducts a unitary business with other commonly owned corporations, it is required to prepare and include with its Illinois combined return a Schedule UB. When calculating the Illinois base income of each member of "ASB's" group whose income and/or loss "ASB" included on Part I line 1 of its original Illinois combined form IL-1120, "ASB" also reported the amount of each such member's

applicable Illinois addition and/or subtraction modifications (as well as the unauthorized subtractions claimed) on Part III of Schedule UB. TMSJ Ex. 2, pp. 6-7 (Schedule UB, Part II "Computation of Federal Taxable Income or Equivalent), 10-11 (Schedule UB, Part III "Computation of Unitary Business Group Income"). The companies whose income and/or losses "ASB" knowingly excluded from the amount of the group's combined federal taxable income, not surprisingly, also had none of the properly reportable Illinois modifications listed on Part III of that same schedule. *Id*.

"ASB" does not aver in its motion that the excluded companies had no Illinois addition modifications (*see* TMSJ), and all but one of the members whose federal taxable income was included on the group's combined had some Illinois modifications. TMSJ Ex. 2, pp. 10-11. Thus, "ASB" has not presented facts sufficient to support "Olsen's" conclusion, or its argument that "… regardless of the propriety of or impropriety of the [its] method of reporting these amounts, ["ASB's"] return ultimately reports the same amount of base income for the year at issue. "ASB's" Brief, p. 5.

More fundamentally, once "ASB" was notified that the Department denied the refund sought in its original return, one has to wonder why in the world it did not simply comply with the rather straightforward commands of §§ 203(b), (e) and 304(e), as well as with the instructions to the returns it filed for the year, and properly report the federal taxable income and/or losses of all of its members on the amended return it filed for 1993, and thereafter, properly calculate the Illinois base income for each such member of its group. In its motion, "ASB" suggests that the income and/or losses of certain members were excluded from its calculation of Illinois base income, "… presumably because it did not have *pro forma* federal income tax returns for this short period[ ]."

Perhaps that is true, but that fact is set forth nowhere in "ASB's" Motion. What I *will* presume, however, is that "ASB" knew why it did not properly report the income and/or losses of each and every member of its unitary group on its original and amended combined returns. I also acknowledge that this record does not disclose why "ASB" took the filing positions it did on the part-year returns for the period it shared common ownership with the other members of its Illinois unitary business group. *See* 86 Ill. Admin. Code § 100.3320(f)(2) (1984).

Regardless what "ASB's" mental state was when it prepared the returns at issue, I agree with "ASB's" counsel that the reason why it took the filing position it did on the pertinent forms IL-1120, IL-1120-X and Schedule UB's is not important here — but not because "ASB's" filing position produced the same result as if it had followed the instructions to those forms. Rather, the reason it is irrelevant is because there is no penalty being contested in this case.

The record is clear that the federal taxable income and/or losses of all members of "ASB's" Illinois unitary business group is not disclosed on the returns "ASB" filed for the period at issue. TMSJ, p. 8 (¶¶54-55); "Olsen" Aff. ¶¶ 25-26. Nor do the returns of record indicate whether any of the excluded members had any amounts required to be reported as Illinois additions on Part III of Schedule UB. Thus, this record does not establish that "ASB" properly calculated and reported the group's Illinois base income and/or losses for the period at issue. TMSJ Ex. 2, pp. 6-7, 10-11. Conjecture as to the reasons underlying "ASB's" filing position, in any event, does not constitute well-pleaded facts which lead to the unmistakable conclusion that "ASB" is entitled to judgment as a matter of law. Skipper Marine Electronics, Inc. v. United Parcel Service, Inc., 210 Ill.

App. 3d 231, 235, 569 N.E.2d 55, 58-59 (1st Dist. 1991) ("… entry of summary judgment has two requisites: the absence of any issue as to a material fact and the unmistakable conclusion of law that the moving party is entitled to the judgment he seeks."). Had "ASB" properly reported the federal taxable income and/or losses of all members of its unitary business group, and then properly calculated the Illinois base income for each such member, there would have been no need for it to invent and use subtraction modifications that are not authorized by IITA § 203(b)(2).

Conclusion

I conclude that "ASB" has not borne its burden to show that the Department improperly denied the refunds claimed by taxpayer's original and amended returns. Therefore, I recommend that summary judgment be entered for the Department, and be denied for "ASB". The Department's denial should be finalized, pursuant to statute.

3/23/01
Date

Administrative Law Judge